

## **Harris County Management Services**

### **Economic Environment - First Quarter Review - June 2010**

#### **Introduction**

The purpose of this report is to update our analysis of the current economic environment and how it might affect the ongoing plans for the fiscal 2010-11 budget at the end of the first quarter.

#### **State of the Economy**

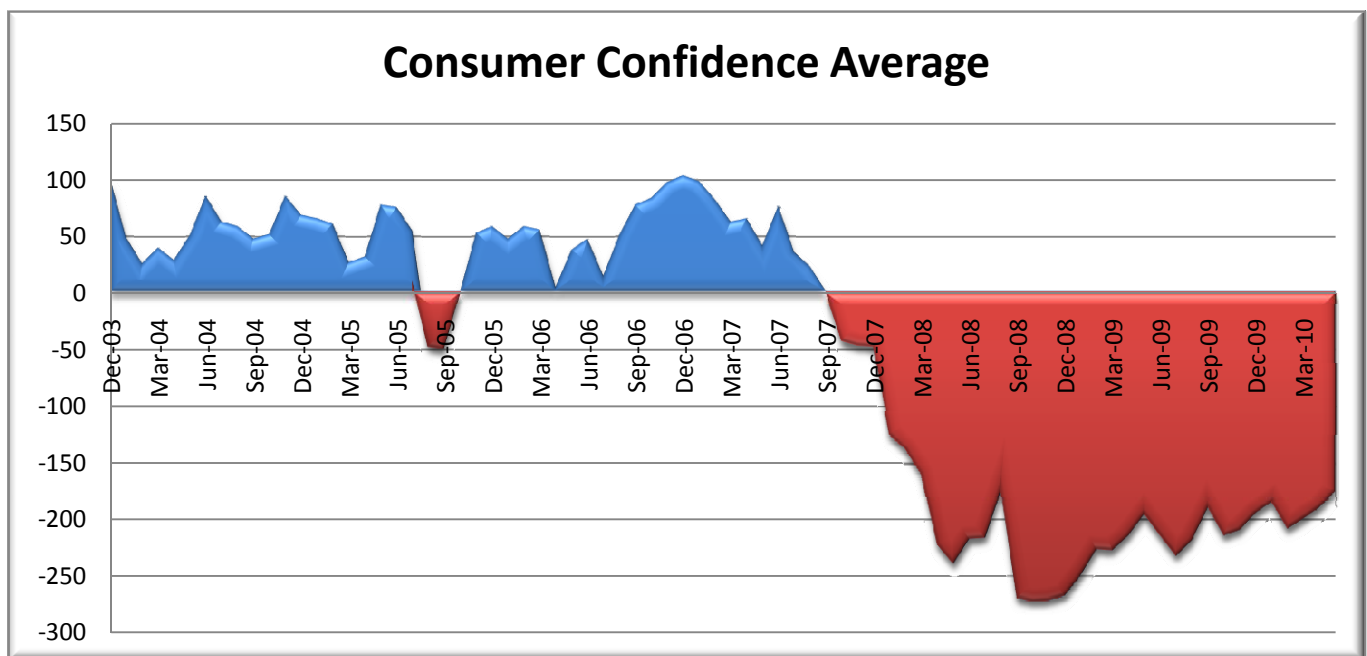
The United States economy is going through a period of uncertainty that started in 2007 and has continued into 2010. Significant fluctuations in energy prices combined with declines in stock market values and fundamental changes in the financial and credit markets have contributed to a high level of concern about where the economy is headed.

Problems in the housing industry resulting from some aggressive and questionable lending practices over the last few years have led to declining home prices and increased foreclosure rates in many parts of the country. Interest rates have declined significantly as the federal funds rate approaches zero and mortgage interest rates continue to be at 50 year lows.

While there are some signs of improvement, it does not appear that the economy has reached the bottom of this current cycle and there are a number of ongoing concerns about major industries, local and state government funds and the potential impacts that inflation and historically high federal deficits could have on the economy over the next few years.

#### **Consumer Confidence is Low**

Consumer confidence had been trending upward during the last quarter of 2009, but declined for the first two months of 2010 before trending upward again. The average has been negative since September 2007 and continues to have a strong adverse effect on the economy.



Restoring consumer confidence in the economy is a key ingredient to re-establishing growth, reducing unemployment and improving the conditions of the financial markets in the US.

## **Harris County Management Services**

### **Economic Environment - First Quarter Review - June 2010**

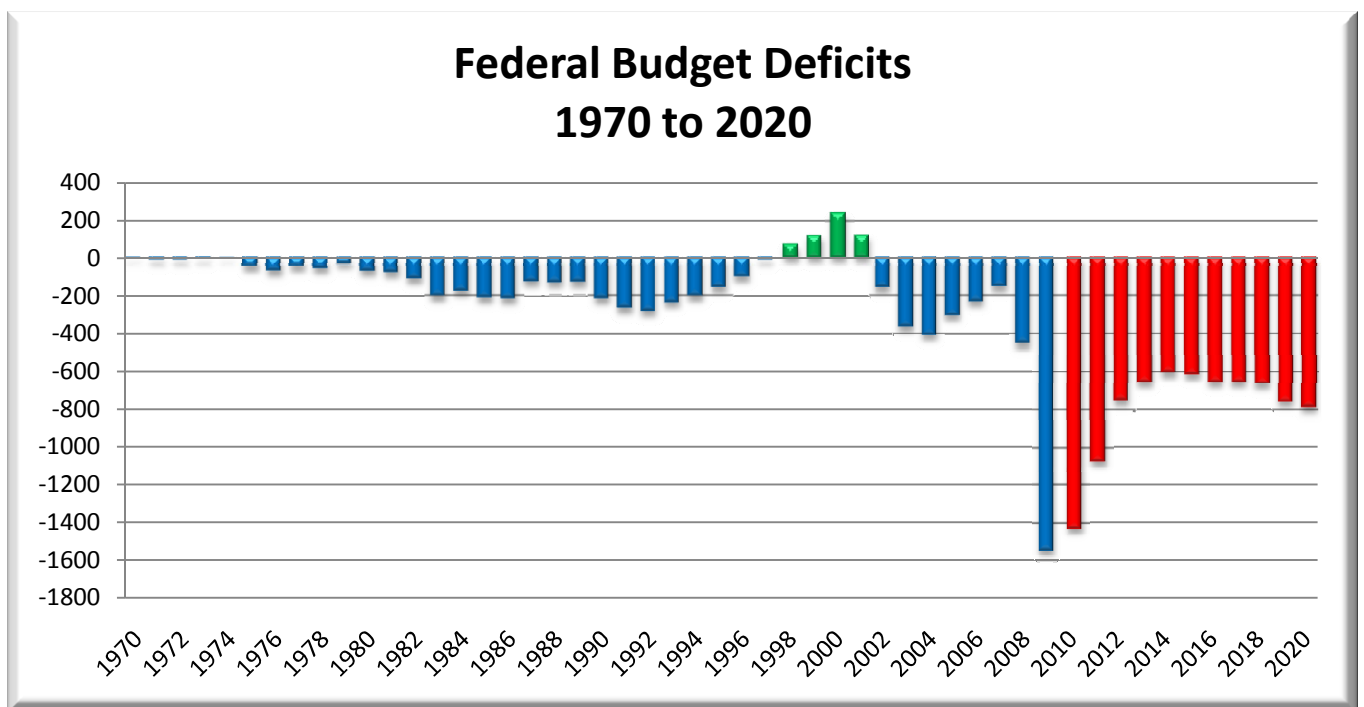
#### **Challenges for Government at all Levels**

According to the national Center on Budget and Policy Priorities, the current recession has caused the "steepest decline in state tax receipts on record." At least 41 states are facing budget challenges in the current fiscal year and all indications are that 2011 will be worse.

County government relies on a combination of property taxes, fees and funding from federal and state governments to conduct operations. A prolonged recession could cause a decline in all sources of county revenue while the need to provide services is increasing.

The current economic downturn could force delays in capital spending programs and require reductions in staffing or discretionary spending that could affect all areas of county government.

The Federal Government is responding to this crisis by significantly increasing federal spending through stimulus programs and industry bailouts, which, coupled with war-related expenditures, are resulting in historic increases in the federal budget deficit using the Congressional Budget Office estimates for 2010 through 2020:



The impact that these deficits will have on interest rates, inflation, taxes and the value of the US dollar are uncertain since this really hasn't happened before in our history. The deficit in 2009 was more than three times higher than the previous record and represents nearly 10% of the total gross domestic product compared to less than 2% in 2008.

Federal spending in excess of tax revenue cannot continue at this pace without having a negative effect on state and local governments. Harris County's access to federal funds and ability to raise money by issuing bonds and other indebtedness could be affected by these deficits.

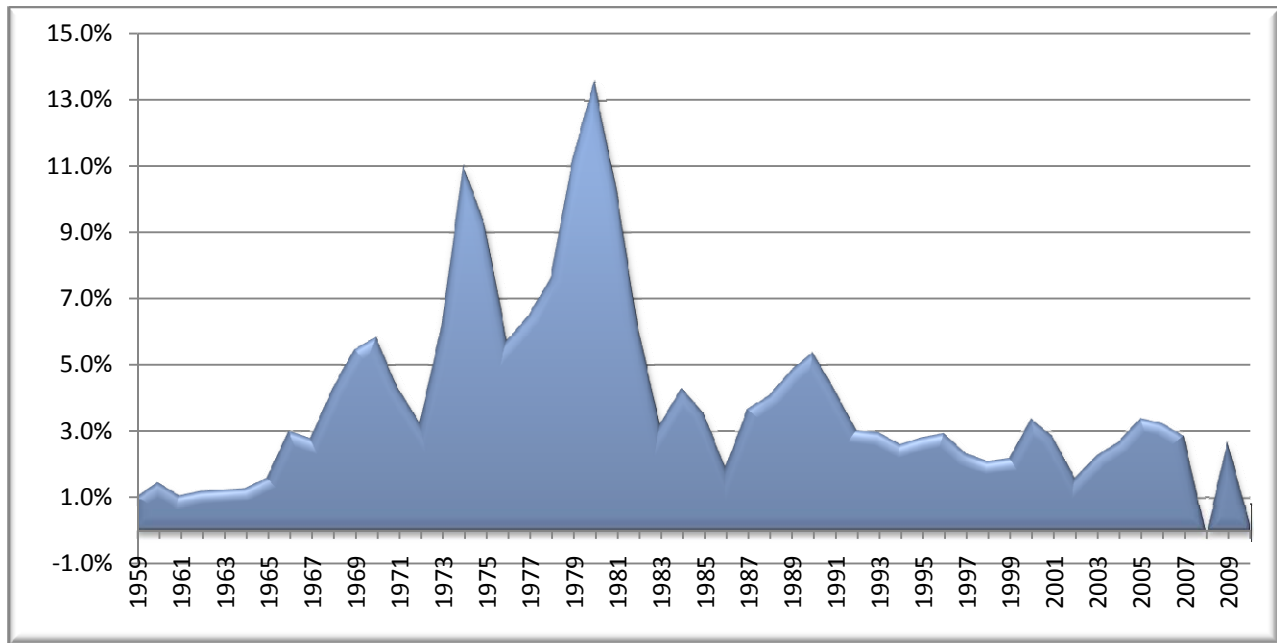
## **Harris County Management Services**

### **Economic Environment - First Quarter Review - June 2010**

#### **Key Economic Indicators**

##### ***Inflation and Growth***

In 2008, the United States had its lowest rate of inflation since 1954. While the overall CPI increased to 2.7% for 2009, it has dropped back to 0.2% for the first four months of 2010.



The Houston-Baytown-Sugar Land Metropolitan Service Area is used by the U.S. Census Bureau and Department of Labor to identify the metropolitan area that includes Harris County and nine contiguous surrounding counties, often called the Greater Houston Area. The Bureau of Labor Statistics publishes an estimated CPI for each major metropolitan area on a bi-monthly basis.

The cost of living for the Greater Houston Area from March 1, 2008 through February 28, 2009, the county's fiscal year, was unchanged while the national average showed a 0.1% decline for the same period.

The cost of living for the fiscal year that ended on February 28, 2010 show that the Greater Houston Area has a slightly lower cost of living index than the national average. Although gasoline prices were higher in January 2010 compared to January 2009, the increase was more than offset by declines of 9.3% for residential electricity and a 22.5% drop in residential natural gas prices for the same periods.

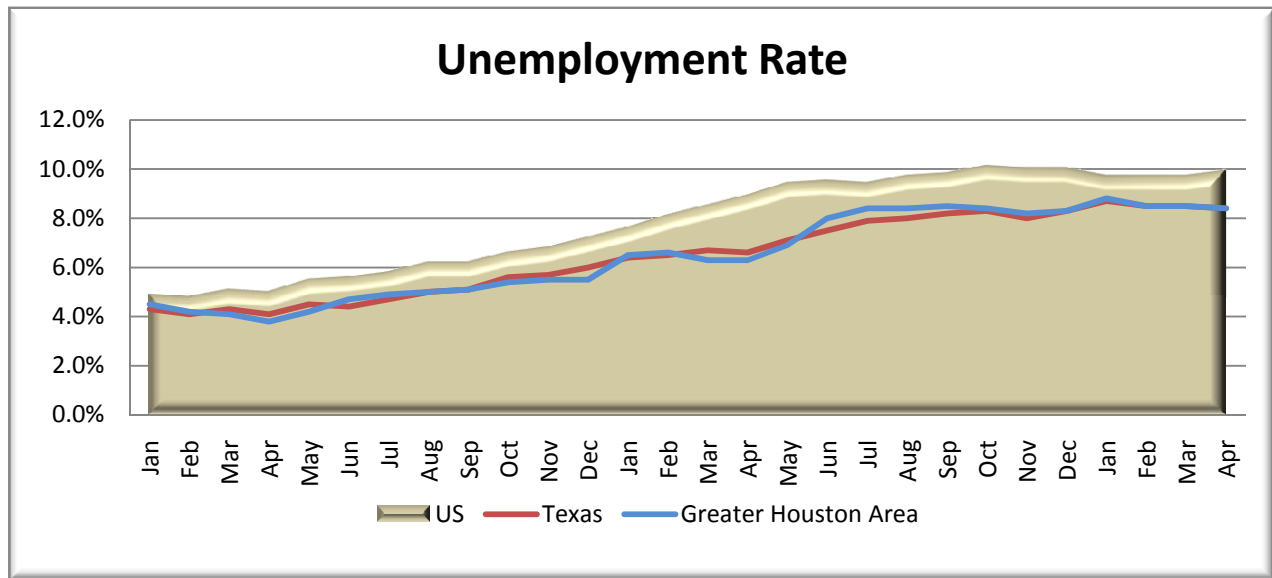
The cost of groceries in the Greater Houston Area for this same period are down 5.8% compared to a 2% drop nationally. Shelter costs in this area rose 1.1%, while the cost of computers and related equipment dropped by 11.5%. Overall, the core inflation rate for this area ended up around 1% for the fiscal year 2009-10. The core inflation rate excludes volatile items such as food and energy prices.

## Harris County Management Services

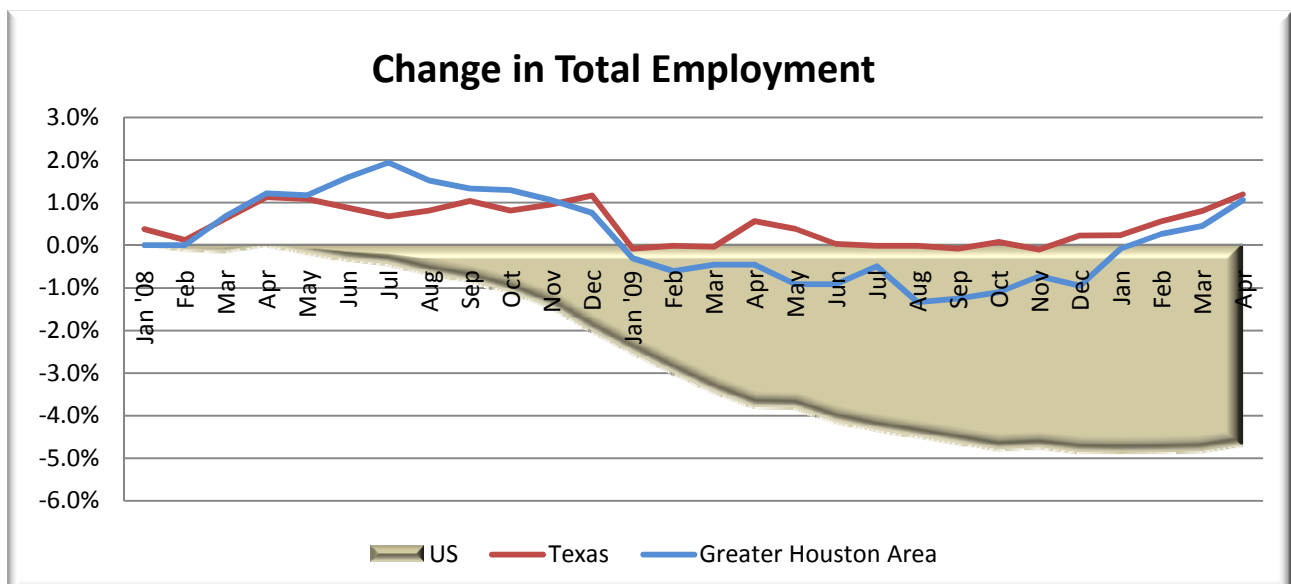
### Economic Environment - First Quarter Review - June 2010

#### ***Jobs***

While inflation rates were similar both at national and local levels, the job market and total employment numbers reflect the continued growth of Texas in general and Harris County in particular. The following graph shows the unemployment rate for the U.S., the State of Texas and the Greater Houston Area since the beginning of 2008.



The total number of people employed in the US declined each month from April 2008 through December 2009 and has started to increase each month during 2010. Total employment in the State of Texas and the Greater Houston Area have also grown steadily since December 2009. The following chart shows the change in total employment for these areas since 2007.

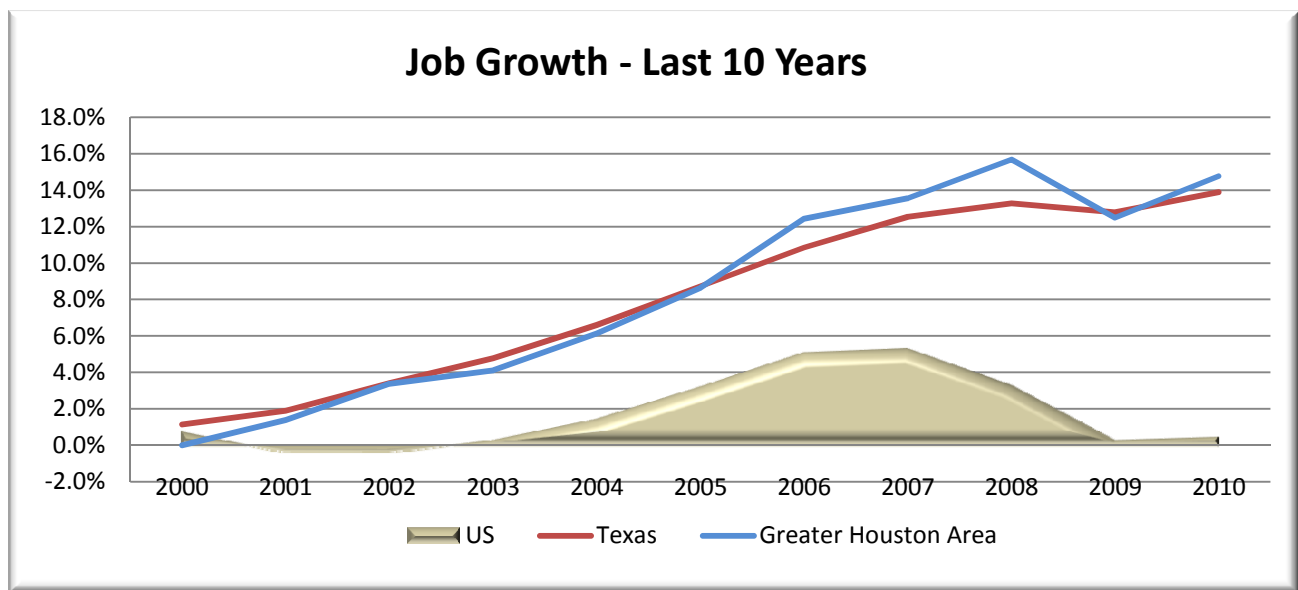


## Harris County Management Services

### Economic Environment - First Quarter Review - June 2010

#### ***Jobs (continued)***

Total employment in the US from December 1999 through April 2010 has grown by 615,000 jobs (0.4%) while the State of Texas has grown by 1.5 million jobs (13.9%) and the Greater Houston Area has grown by 347,000 jobs (14.8%). Outside of Texas, the other 49 states actually saw a decline of more than 300,000 jobs in this decade and Texas now accounts for 8% of all US jobs up from 7.1% in 2000. Harris County now accounts for 1.9% of all US jobs, up from 1.7% ten years ago.



Job growth at the state and local level has been a result of a vibrant economy, relatively modest cost of living and an influx of workers from other states. However, it is clear that the slowdown in economic activity has begun to affect Harris County. This area is not immune to the effects of the slumping economy as it continues and energy prices remain low. The following data on Harris County show that the impact is underway.

#### ***The Stock Market and Interest Rates***

The value of stocks dropped significantly during 2008 and the first part of 2009, adding more uncertainty to the economy and further eroding consumer confidence and the values of savings accounts, pension funds and investment assets throughout the economy. The Dow Jones Industrial Average dropped by 34% during 2008, while the S&P 500 dropped 38% in value over the same period. The Dow fell another 27% from January 2009 through early March 2009, but has since rebounded to levels similar to November 2008.

Interest rates have also fallen significantly since 2007. The Federal Funds Rate, charged by the Federal Reserve to banks and other lending institutions, has dropped from over 5% in early 2008 to less than 1% in October and to an all time low of 1/4 of 1% in December 2008. This rate had not been below 1% since 1956. It has remained between 0% and 1/4 of 1% for all of 2009.

## Harris County Management Services

### Economic Environment - First Quarter Review - June 2010

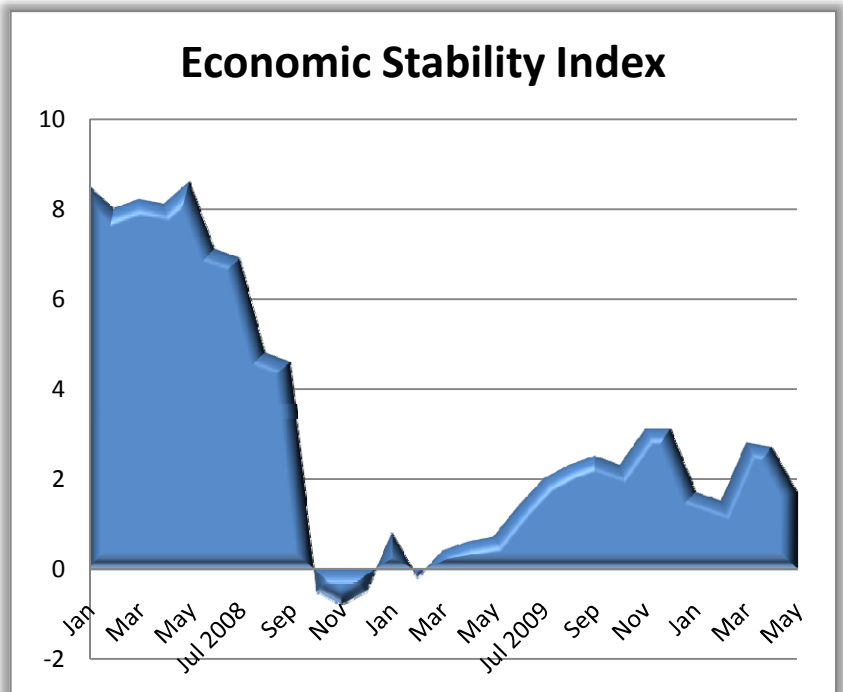
#### ***Economic Stability Index***

We have developed a new index to attempt to show how all of these economic factors have led to the current level of uncertainty and concern. This index takes the Dow Jones Industrial Average in thousands plus economic growth minus the unemployment rate to measure the degree of stability in the overall economy.

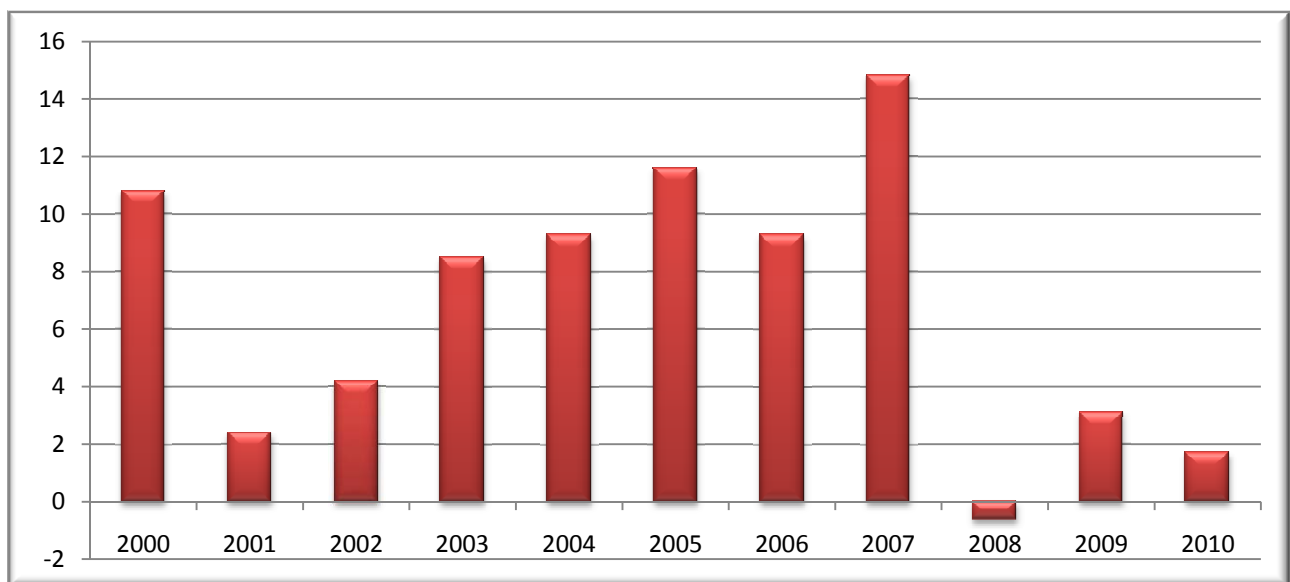
The economy is more stable when this index is high. For the first time since 1993, the index went below zero in October 2008 and remained low through early 2009.

Starting in July and August, the economy started to grow as did the stock market causing this index to rebound despite the high unemployment rates which continue through May.

The unemployment rate passed 10% in 2009 for the first time since June of 1983 and the rate has remained close to 10% in first quarter of 2010.



The following graph shows the index at the end of each of the last 10 years.



## Harris County Management Services

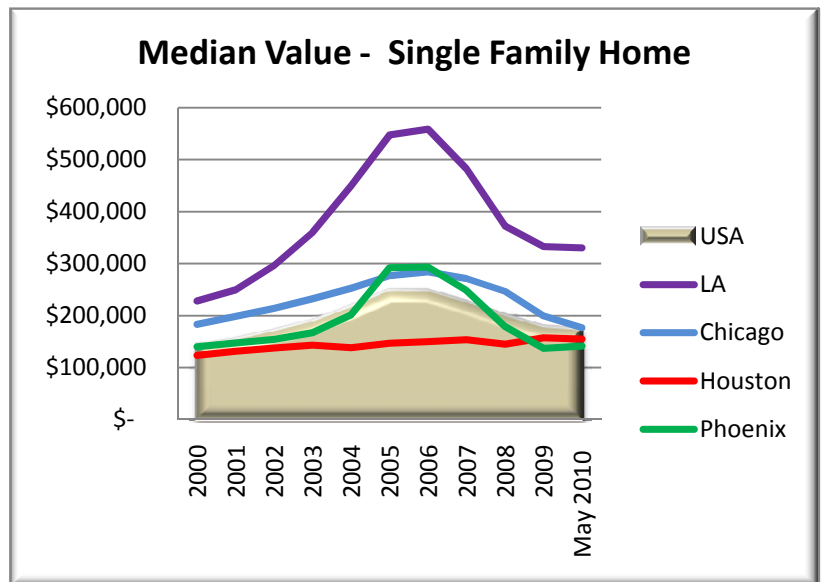
### Economic Environment - First Quarter Review - June 2010

#### ***Harris County Real Estate***

Harris County real estate prices have traditionally been lower than the national average. The chart below shows the median value of a single family home for the cities located in the four largest counties in the U.S. as well as the average for the U.S. as a whole.

Home prices in Houston did not increase during this period nearly as fast as they did in LA, Phoenix or the rest of the country. As a result, Houston also did not experience the significant drop in home values over the last few years.

In fact, the median value of a single family home in Houston is now higher than the median value in Phoenix, Arizona. In 2005, the Phoenix median value was double the Houston value.



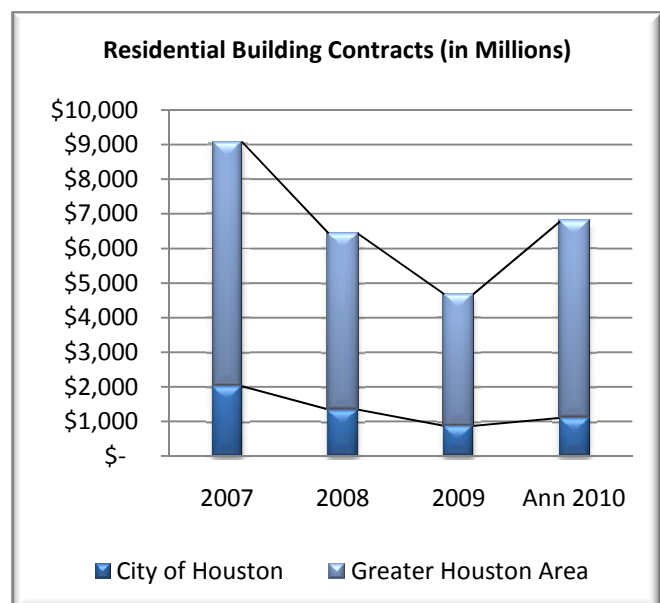
Foreclosure rates in the previously rapid growth areas of California, Nevada, Arizona and Florida range from 4.8% to over 10% of all homes, while the foreclosure rate in Harris County was less than 1% in 2009 and remained low through the first half of 2010.

#### ***Trends in Residential Real Estate***

The slowdown in economic growth has started to affect the Houston area although certainly not as hard as other areas. The dollar value of residential building contracts in the Greater Houston Area declined by 27% from \$9.1 billion in 2007 to \$6.4 billion in 2008 and \$4.7 billion in 2009.

Within the City of Houston, permits for construction of new homes fell by 33% from \$2.0 billion in 2007 to \$1.4 billion in 2008 to \$880 million in 2009.

For the first 4 months of 2010, residential construction contracts were up 32% county-wide and 19% in the City of Houston. If this trend were to continue, the total for 2010 would return to the 2008 levels seen before the economic downturn.



## Harris County Management Services

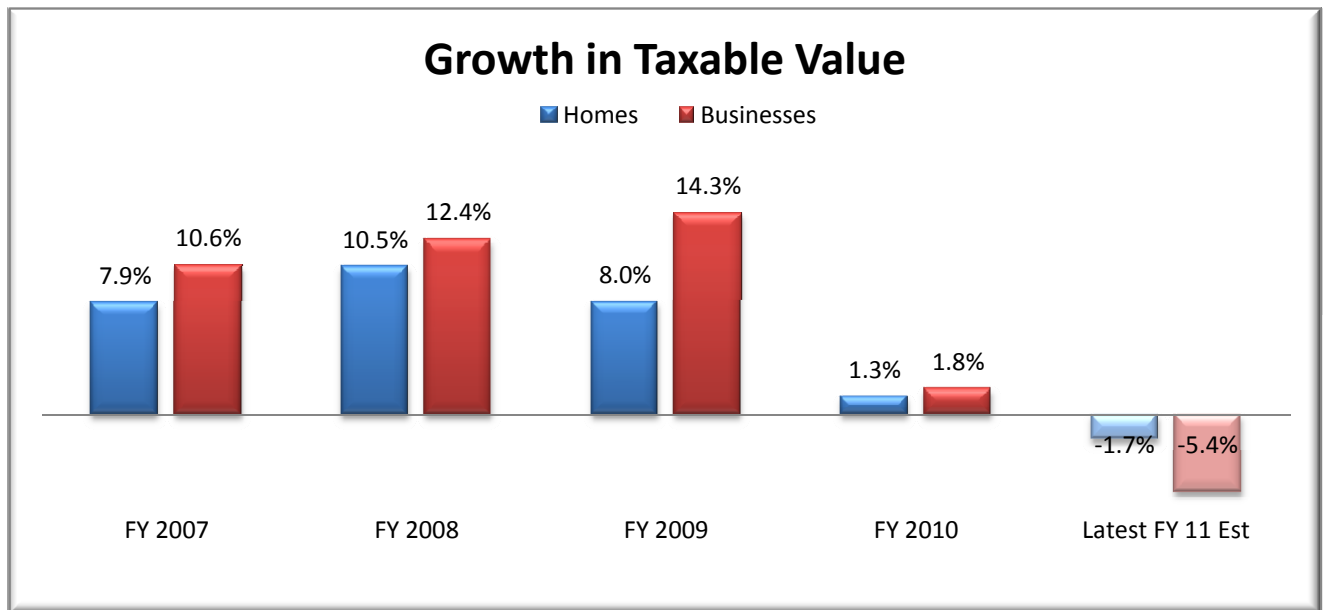
### Economic Environment - First Quarter Review - June 2010

#### ***Real Estate Appraisal Data***

Property appraisals conducted by the Harris County Appraisal District (HCAD) each year can be a good indicator of economic stability and growth. The following analysis is based on HCAD data from January 1, 2005 through the latest appraisals done as of January 1, 2009 along with preliminary estimates by HCAD of the 2010 taxable values.

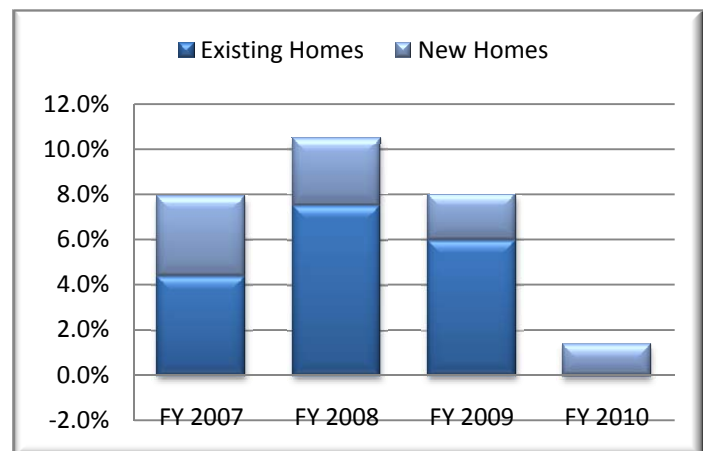
Due to the dynamic growth in population and the number of new homes and businesses in Harris County, the market value of all property grew by double digits from 2005 through 2008 but flattened considerably in 2009 and is estimated by HCAD to experience a decline in 2010.

The following chart shows the growth rate for homes and businesses in Harris County for each of the last 4 years along with a preliminary estimate for 2010. The value of business property has grown faster than residential property but both are expected to decline for the upcoming budget year.



The addition of new single family homes each year has helped the growth percentages to remain strong during this period. Virtually all of the value increase in 2009 is due to new construction. This chart shows the effect of new homes on the growth rates.

This growth in new property has caused the taxable value to increase from 70% of market value in 2005 to 72% of market value in 2009 with a drop in the amount of the 10% homestead cap from 1.9% of market to 1.4% of market value.



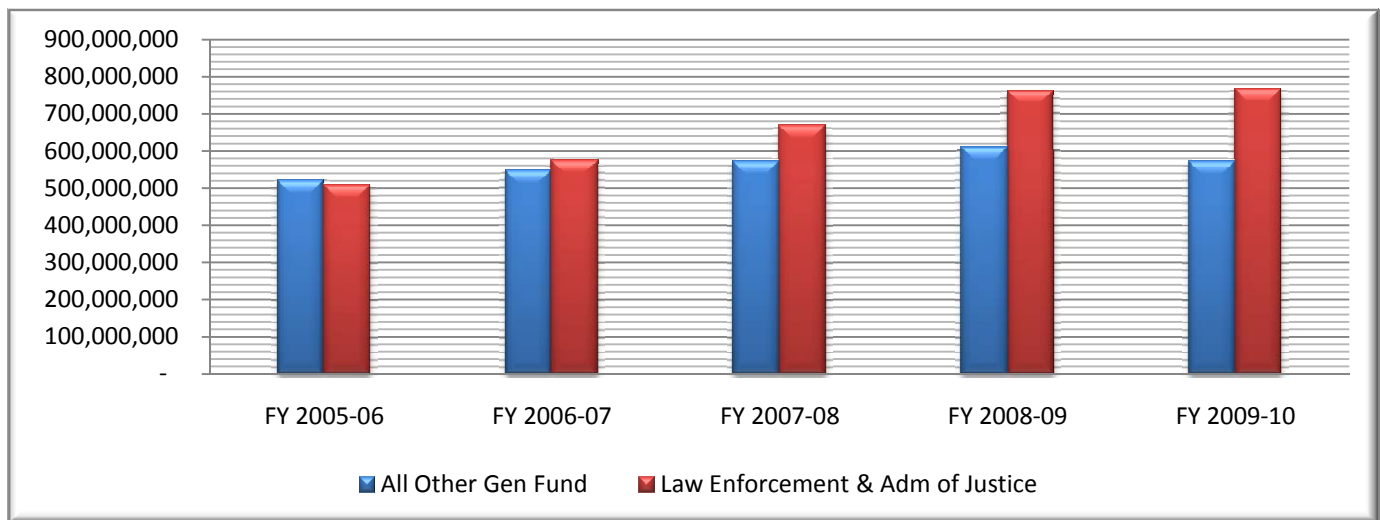


## Harris County Management Services

### Economic Environment - First Quarter Review - June 2010

#### ***Economics of Law Enforcement***

Harris County government has a primary role in virtually all aspects of law enforcement and the administration of justice in this region. Since 2005, the cost of providing law enforcement from patrol to arrest to prosecution to conviction and incarceration has grown significantly faster than cost of other county services. The following chart shows the growth in county spending related to the Sheriff's office, the Constables, the District Attorney, the County Attorney, Fire Marshal, Juvenile Probation and the cost of providing court-appointed attorneys compared to the growth of other county general fund spending.



The cost of law enforcement has grown by 51% from \$508 million to more than \$766 million over this period of time. All other general fund spending has only gone up 10%, from \$520 million to \$573 million, since 2005. The percentage of general fund resources spent on law enforcement has grown from 49% in fiscal year 2005-06 to over 57% in the current fiscal year.

Until the economy starts to improve, it is very likely that property taxes and other general fund revenues will be flat or declining for the next few fiscal years. The trend for rapidly growing law enforcement expenditures may need to be reversed or tempered until the economy improves.

Harris County has already taken steps to address this problem by adopting some alternatives to detention for juveniles and alternative sentencing for some adults as well as forming a council to look at criminal justice coordination and alternatives. The pressures of increasing jail populations and the need to provide services to a rapidly growing unincorporated area will cause this issue to remain at the forefront until the economy turns around and the growth in available resources returns.

#### **Conclusion and Recommendation**

The continued high unemployment rates along with the growing federal deficit have contributed to the ongoing lack of consumer confidence in the economy. Until confidence can be restored and job growth re-established, there is a need to be cautious in county spending both for operations and capital projects.